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In the Supreme Court of the United States

OCTOBER TERM, 1991

KRAFT GENERAL FOODS, INC.
(Formerly KRAFT, INC.), PETITIONER

v.

IOWA DEPARTMENT OF REVENUE AND FINANCE

ON WRIT OF CERTIORARI TO THE SUPREME COURT OF IOWA

BRIEF FOR THE UNITED STATES AS AMICUS CURIAE SUPPORTING RESPONDENT

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QUESTION PRESENTED

Whether Iowa discriminates against foreign commerce in violation of the Commerce Clause or the Equal Protection Clause of the Constitution of the United States by imposing its annual tax on the apportioned "net income" of corporations doing business in the State and by defining "net income" for this purpose to mean "the taxable income * * * as properly computed for federal income tax purposes under the Internal Revenue Code" (Iowa Code Ann. § 422.35 (West 1990)).

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INTEREST OF THE UNITED STATES

The Constitution vests legislative power in the Congress to "lay and collect taxes on incomes" (U.S. Const. Amend. XVI) and to "regulate Commerce with foreign Nations" (U.S. Const. Art. I, § 8, Cl. 3). It is contended in this case that Iowa has violated the Commerce Clause and the Equal Protection Clause by enacting a tax scheme that incorporates some, but not all, of the provisions of the Internal Revenue Code affecting the treatment of dividend income received by a corporation from foreign-incorporated subsidiaries. The effects of the federal statutory scheme are thus central to evaluation of the claims in this case. At the Court's invitation, the United States filed a brief *amicus curiae* at the petition stage of this case.

STATEMENT

1. Petitioner is a Delaware corporation with its principal place of business in Illinois.[1] During 1981, petitioner conducted a unitary business within the United States and, through foreign subsidiaries, in certain foreign countries.[2] Part of this unitary business was conducted by petitioner in the State of Iowa. Pet. App. 28a-29a, 33a.

On June 3, 1985, the Director of Revenue of the State of Iowa issued a notice of assessment to petitioner for taxes, interest, and fees due for 1981 in the aggregate amount of $51,756.62 (Pet. App. 32a-33a). The assessment was made under Section 422.33 of the Iowa Code Ann. (West 1990), which imposes an annual tax on the apportioned "net income" of corporations doing business in the State (Pet. App. 3a, 58a). Section 422.35 of the Iowa Code Ann. (West 1990) (Pet. App. 62a), with adjustments not at issue here, defines the term "net income" as "taxable income * * * as properly computed for federal income tax purposes under the Internal Revenue Code of 1954." The Iowa Code thus incorporates federal "taxable income" as the base upon which the State's annual tax upon corporate "net income" is computed.

With respect to corporations, Section 63(a) of the Internal Revenue Code[3] defines "taxable income" as

[1] Petitioner is the successor by merger of another Delaware corporation, Kraft, Inc., that during calendar year 1981 had its principal office and commercial domicile in Illinois and was qualified to do business, and did business, in Iowa. References in this brief to "petitioner" are either to the corporation active at the time referred to, or to both corporations.

[2] The record does not identify the States (other than Iowa and Illinois) or the foreign countries in which petitioner conducted its unitary business.

[3] References to the Internal Revenue Code are, unless otherwise indicated, to the Internal Revenue Code of 1954 (26 U.S.C.) as amended and effective during 1981.

"gross income minus the deductions allowed by this chapter." 26 U.S.C. 63(a). The term "gross income" includes "dividends" (26 U.S.C. 61(a)(7)),[4] but, in 1981, Section 243 of the Code allowed a corporation to deduct 85%[5] of the dividends it received from another *domestic* corporation that was itself subject to the federal income tax and 100% of the dividends it received from such a *domestic* corporation that it controlled by ownership of at least 80% of its stock.[6] 26 U.S.C. 243 (1979).[7] Dividends received from a *foreign* corporation that was not subject to the federal income tax,[8] however, were not deductible in determining the "taxable income" of a corporation under the Internal Revenue Code. The Code, however, provides an election to the corporate taxpayer

[4] The term "dividends" is defined in 26 U.S.C. 316(a).

[5] Section 243 has been amended several times since 1981. The dividends-received deduction remains at 100% in the case of dividends from affiliated corporations or from certain small business investment companies, but is now generally 70% in the case of other eligible dividends. 26 U.S.C. 243.

[6] The deductions are available only if the domestic corporations that paid the dividends are themselves subject to the federal income tax. 26 U.S.C. 243.

[7] The term "domestic corporation" is defined in Section 7701(a)(4) of the Code as a corporation organized under the law of the United States or of any State. 26 U.S.C. 7701(a)(4). Throughout this brief, the term "domestic corporation" will be used with this meaning, and the term "foreign corporation" will refer to a corporation incorporated outside the United States.

[8] Dividends paid by a foreign corporation may be deductible in part, to the extent that they, like domestic corporations, are subject to United States taxation. Section 882 of the Internal Revenue Code imposes the federal income tax upon foreign corporations to the extent that such corporations receive "taxable income which is effectively connected with the conduct of a trade or business within the United States." 26 U.S.C. 882(a)(1). Under Section 245(a)(3) of the Code, as it has been amended from time to time, the dividends paid by a foreign corporation that is subject to the federal income tax may, in specified circumstances, be deducted in determining the

either to deduct the foreign income taxes it has paid on earnings from its own foreign operations and on dividends received from a foreign corporation (26 U.S.C. 164(a)(3)) or, instead, to take a credit against its federal income taxes based on (i) the amount of the foreign income taxes it paid (26 U.S.C. 901) and (ii) the amount of foreign income taxes paid by a foreign-incorporated subsidiary with respect to the fraction of the earnings distributed as dividends to the taxpayer (26 U.S.C. 902).[9] If the taxpayer elects to take the tax credits allowed by Sections 901 and 902, it may not take the deduction for foreign income taxes allowed by Section 164. See 26 U.S.C. 275(a)(4).

As a result, when a corporate taxpayer received dividends in 1981, whether from domestic or from foreign corporations, the Internal Revenue Code required that the amount of those dividends be included in gross income, but then, in computing "taxable income," allowed

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taxable income of the recipient corporation. The current form of Section 245 provides that a domestic corporation that owns at least 10% of the stock of a foreign corporation may deduct the portion of the dividends that it receives from that corporation that reflects the earnings of the foreign corporation from "the conduct of a trade or business within the United States and subject to [the federal income] tax." 26 U.S.C. 245(a)(5)(A). Additionally, the dividends received by a domestic parent from a wholly-owned foreign subsidiary are fully deductible if all of the income of the foreign subsidiary "is effectively connected (or treated as effectively connected) with the conduct of a trade or business within the United States." 26 U.S.C. 245(b)(1). During 1981, Section 245(a) was somewhat more restrictive, requiring, for example, the foreign corporation to have engaged in a significant portion of its business in the United States for a period of at least 36 months for its dividends to qualify for the deduction. 26 U.S.C. 245(a) (1979).

[9] This portion of the foreign income taxes paid by the foreign subsidiary is "deemed to have [been] paid" (26 U.S.C. 902(a)) by the domestic parent corporation for the purpose of computing its federal income tax credit. The Court has recently considered some of the questions arising with respect to the credit provided by Section 902 in *United States* v. *Goodyear Tire & Rubber Co.*, 493 U.S. 132 (1989).

a deduction of 85% or 100%, as the case might be, of the amount of dividends received from taxable domestic corporations. In basing its corporate income tax upon an apportioned fraction of "net income," defined as "the taxable income * * * as properly computed for federal income tax purposes," Iowa to that extent accepts and follows the federal pattern. Iowa also follows the federal pattern in which deductions (including the deduction for foreign income taxes paid by the taxpayer) reduce "taxable income," but in which income tax credits elected by the taxpayer (under Sections 901 and 902) in lieu of deductions (under Section 164) do not.

During 1981, petitioner owned more than 80% of the stock of several corporations organized and conducting their respective segments of petitioner's unitary business outside the Untied States. Six of those foreign subsidiaries paid dividends in that year in the aggregate amount of $10,181,815, of which, after foreign income taxes in the amount of $1,490,887 were withheld,[10] petitioner received $8,690,928 (Pet. App. 52a-53a).[11] On its federal income tax return for 1981, petitioner included the foreign subsidiary dividends as part of its gross income and elected to claim a credit against its federal

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[10] Sections 1441 and 1442 of the Internal Revenue Code similarly impose a tax withholding obligation for dividends and certain other regular payments to nonresident aliens and foreign corporations. The federal withholding is at the rate of 30% except as reduced by treaty provisions. See 26 U.S.C. 1441(a), 1442(a).

[11] The stipulated facts do not disclose what fraction of petitioner's net income was apportioned to, and taxed by Iowa, and what fractions were apportioned to what other States. Similarly, those facts do not disclose whether petitioner itself engaged in business beyond, as well as within, the United States, and might have had other deductible, or creditable, foreign income taxes. In conformity with Rule 29.1 of the Rules of this Court, petitioner lists 86 subsidiaries other than wholly owned subsidiaries (Br. App. 1a-3a). The names suggest that most, if not all, are foreign corporations. The list does not include the six subsidiaries (identified at Pet. App. 52a-53a and Br. 3) whose dividends are at issue in this case.

income tax, rather than a deduction, with respect to the foreign taxes it paid (*id.* at 32a).[12]

In computing "net income" on its Iowa corporate income tax return for 1981, petitioner did not adhere to the definition of "taxable income" in the Internal Revenue Code. Instead, petitioner deducted from its reported federal "taxable income" the dividends that it had received from its foreign subsidiaries (Pet. App. 32a). The deficiency assessed by the Director of Revenue of the State of Iowa required those foreign dividends to be included in petitioner's "net income" because the dividends from those foreign corporations did not give rise to a deduction in computing "taxable income" under the Internal Revenue Code (*id.* at 32a-33a).

Petitioner protested the asserted deficiency to the Iowa State Department of Revenue and Finance, asserting that inclusion of the dividends it received from foreign subsidiaries in its net income discriminated against foreign commerce, in violation of the Commerce Clause of the Constitution of the United States, and denied it the equal protection of the laws in violation of the Fourteenth Amendment. The Director of Revenue and Finance denied the protest, noting that he had no authority to question or decide the constitutionality of the State's laws (Pet. App. 24a-27a).

2. The District Court of Polk County, acting on the basis of a stipulated record (Pet. App. 28a-56a), upheld the assessment (*id.* at 11a-23a). The court held that "Kraft has not shown that the Iowa tax in any way benefited local in-state industry in detriment to out-of-state industry" (*id.* at 16a) and "has not shown that the Iowa tax exerts a pressure on interstate business to conduct more of it activities in Iowa" (*id.* at 17a). The court characterized as "wholly speculative" the argument that if other States followed the Iowa pattern, "it would

[12] If petitioner had not elected the tax credit, its "taxable income" (for both federal and Iowa purposes) would have been reduced by the amount of foreign taxes that petitioner paid.

be a 'powerful persuader' to locate foreign operations within U.S. boundaries" (*ibid.*). The court therefore rejected (*id.* at 22a-23a) petitioner's Commerce Clause and equal protection claims.

3. The Supreme Court of Iowa affirmed (Pet. App. 1a-10a). In response to petitioner's charge that the Iowa corporate income tax discriminated against foreign commerce, the court stated that "the question is whether Iowa businesses are benefited at the expense of foreign businesses" (*id.* at 7a) and concluded that "[b]ecause the Iowa tax does not differentiate between in-state or out-of-state taxpayers no impermissible discrimination exists" (*id.* at 7a-8a). The court also rejected petitioner's equal protection claim, noting (*id.* at 9a) that no suspect classification or fundamental right was at issue and that use of the federal concept of "taxable income" served legitimate state purposes (as well as the convenience of taxpayers) in promoting economy of effort, convenience, and administrative efficiency (*id.* at 9a-10a).

SUMMARY OF ARGUMENT

I

Petitioner's contention that the different treatment under Iowa law of dividend income paid by foreign and domestic corporations "facially discriminates against foreign commerce" (Pet. Br. 11) is not correct. Under the Internal Revenue Code, as incorporated in the Iowa statute, the deductibility of dividends, whether paid by domestic *or* foreign corporations, generally depends upon whether, and to what extent, the earnings that were the source of the dividends were subject to tax in the United States. While there are differences in the treatment afforded to dividend income based upon the place of incorporation of the distributing corporation, those differences do not effect a discrimination based upon the location or nature of the commerce conducted. Domestic corporations may, and do, engage in foreign commerce; foreign corporations may, and do, engage in domestic

commerce. The distinctions made in the taxation of dividends paid by domestic and foreign corporations under the Internal Revenue Code and under Iowa law do not equate to distinctions based upon whether foreign or domestic commerce is involved.

Even if one accepts, however, the conceptual simplification that foreign corporations engage only in foreign commerce and domestic corporations engage only in domestic commerce, it is domestic commerce, rather than foreign commerce, that is "facially" subject to the greater burden under the Iowa scheme. The entire earnings of domestic subsidiaries (whether from domestic or foreign commerce) are subject to tax at the state level under the Iowa scheme; by contrast, only that part of the foreign earnings of a foreign subsidiary that is distributed to its domestic parent as a dividend is subject to tax at the state level under the Iowa scheme. The unitary business enterprise may thus achieve a benefit, rather than suffer a detriment, from conducting its foreign commerce by means of a foreign-incorporated subsidiary. Moreover, the Iowa scheme would allow the parent corporation, through use of a domestic subsidiary holding company, to elect tax treatment for foreign subsidiary income that is identical to the treatment of such income for a domestic subsidiary.

II

Since the Iowa tax does not discriminate against foreign-incorporated subsidiaries (much less against foreign commerce), there is no violation of either the Commerce Clause or the Equal Protection Clause. The different treatment of dividends received by a unitary business enterprise from foreign-incorporated, as compared to those from domestic-incorporated, subsidiaries serves legitimate, rational state purposes.

ARGUMENT

I. THE IOWA TAX DOES NOT VIOLATE THE FOREIGN COMMERCE CLAUSE

A state tax may unconstitutionally discriminate against foreign commerce if it "is facially discriminatory, has a discriminatory intent, or has the effect of unduly burdening [such] commerce" (*Amerada Hess Corp.* v. *Director*, 490 U.S. 66, 75 (1989)). Petitioner has offered no evidence in this case to suggest that the Iowa tax has a discriminatory intent or that it creates undue burdens on foreign commerce. Petitioner instead relies upon the assertion that the "Iowa tax scheme facially discriminates against foreign commerce" (Pet. Br. 11). The claim of facial discrimination against foreign commerce is not correct. The judgment of the Iowa Supreme Court should therefore be affirmed.[13]

A. The Iowa Tax Does Not Discriminate Against Foreign Commerce

Petitioner contends (Pet. Br. 11, 14-16) that the Iowa tax "facially discriminates against foreign commerce" because the dividends that a domestic parent corporation receives from a wholly-owned *foreign* subsidiary are included in its apportioned "net income" under state law while the dividends the parent receives from a wholly-owned *domestic* subsidiary are not. Petitioner's claim that this different treatment of foreign and domestic subsidiary dividend income under Iowa law represents a facial discrimination against "foreign commerce" errs

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[13] Petitioner contends that the facial discrimination against foreign commerce effected by the Iowa tax violates both the Commerce Clause and the Equal Protection Clause (Pet. Br. 14-17, 24-30). Because the Iowa scheme does *not* discriminate against foreign commerce, neither the Commerce Clause nor the Equal Protection Clause is properly invoked in this case. See page 23, *infra*.

in two respects: (i) it unduly equates the nature of the commerce conducted by a corporation with the location of its incorporation; and (ii) it erroneously views Iowa's treatment of dividends in isolation from all other features of the Iowa and federal tax schemes. As this Court stated in *Halliburton Oil Well Cementing Co.* v. *Reilly*, 373 U.S. 64 (1963), the constitutionality of a particular state tax provision must not be "[c]onsidered in isolation" (*id.* at 69). "[A] proper analysis must take the 'whole scheme of taxation into account.'" *Ibid.* (quoting *Galveston, H. & S.A. R.R.* v. *Texas*, 210 U.S. 217, 227 (1908)).

1. Under the Internal Revenue Code, as incorporated in the Iowa statute, the deductibility of dividends, whether paid by a domestic or foreign corporation, generally depends upon whether, and to what extent, the earnings that were the source of the dividends were subject to tax in the United States. Under Section 11 of the Internal Revenue Code, all of the earnings of domestic business corporations, whether derived from domestic or foreign commerce, are subject to the federal income tax (26 U.S.C. 11); Section 243 then allows a deduction for the receipt of dividends from such domestic corporations (26 U.S.C. 243). Under Section 882 of the Code, only the domestic earnings of foreign corporations are subject to the federal income tax (26 U.S.C. 882); Section 245, with certain limitations, therefore allows a deduction for the receipt of dividends paid from the domestic earnings of such foreign corporations (26 U.S.C. 245). The *foreign* earnings of foreign corporations are not, however, subject to the federal income tax (see 26 U.S.C. 882), and therefore no deduction is allowed for the receipt of a dividend paid from the foreign earnings of such foreign corporations (see 26 U.S.C. 245). See note 8, *supra*.

A differentiation in the treatment of dividend income that is based upon the subsidiary's place of incorporation

is thus not equivalent to a discrimination based upon the location or character of the commerce conducted by that corporation. A domestic subsidiary may, and often does, engage in foreign commerce; when it does, its foreign earnings are subject to the federal income tax. A foreign subsidiary may, and often does, engage in domestic commerce; when it does, its domestic earnings are subject to the federal income tax. In both of these situations, a deduction for dividends distributed from these earnings is available. But the *foreign* earnings of a foreign subsidiary are not subject to the federal income tax; as a corollary, a deduction is *not* available for dividends distributed from those untaxed earnings. The Iowa tax, by incorporating the federal distinctions, differentiates in its treatment of dividend income based upon the place of incorporation of the subsidiaries and whether those subsidiaries are themelves subject to domestic taxation (see notes 6 & 8, *supra*), not simply upon "the location of their activities" (*Amerada Hess Corp.* v. *Director*, 490 U.S. at 78).[14]

Just as Delaware corporations, such as petitioner, often earn significant portions of their income from commerce conducted outside of Delaware (and, indeed, outside of the United States), foreign corporations do not necessarily earn all of their income from commerce conducted abroad. It is therefore incorrect to equate distinctions based upon the location of incorporation with distinc-

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[14] For example, a domestic corporation and a foreign corporation might each earn 50% of their income from domestic commerce and 50% of their income from foreign commerce. Different treatment of the dividends paid by these corporations in assessing a tax against the domestic recipient would not be a discrimination based upon the type of commerce involved. Instead, as we discuss at pages 16-23, *infra*, the different tax treatment of the two dividends in this situation reflects rational efforts to allocate taxing authority among affected governments. See also note 8, *supra*.

tions based upon the location or type of commerce being conducted.[15] The situation is, in reality, far more complex.[16]

2. Even if one accepts, however, the conceptual simplification that foreign corporations engage only in foreign commerce and domestic corporations engage only in domestic commerce, the Iowa tax does not systematically or "facially" discriminate against foreign commerce.[17] In fact, domestic commerce is "facially" subject to the greater burden under the Iowa scheme.

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[15] The cases on which petitioner and its amici principally rely involve situations where the state tax applied differently based solely upon whether imported or domestic goods were involved. See, *e.g.*, *Cook* v. *Pennsylvania*, 97 U.S. 566 (1878) (differential tax on imported wares); *Hale* v. *Bimco Trading Co.*, 306 U.S. 375 (1939) (inspection fee on imported cement). Those decisions do not support a claim that differential treatment of foreign and domestic corporations is sufficient to establish that the State is engaged in discrimination against foreign commerce.

[16] See note 14, *supra*; B. Bittker & J. Eustice, *Federal Income Taxation of Corporations and Shareholders* ¶¶ 17.01-17.44 (5th ed. 1987). Petitioner attempts to avoid these complexities by theorizing that Iowa differentiates between its treatment of dividends paid from the *foreign* earnings of foreign subsidiaries (a construct that petitioner describes broadly as "foreign subsidiary dividends" (Pet. Br. 5-6 & n.5)) and dividends paid from the earnings of domestic subsidiaries (*ibid.*). Petitioner errs, however, in suggesting that its definitions draw a neat line between foreign and domestic commerce: (i) dividends paid by a domestic subsidiary may have their source in earnings from *foreign* commerce, but the dividends would still be deductible in determining the taxable income of the domestic corporation receiving those dividends (see note 20, *infra*); (ii) dividends paid by a foreign corporation may have their source in earnings from *domestic* commerce but, in at least some circumstances, would still *not* be deductible in determining the taxable income of the domestic corporation receiving those dividends (see note 8, *supra*). The differentiation in the treatment of dividends under the federal and Iowa statutes cannot smoothly be fitted into separate categories for domestic and foreign commerce.

[17] Nor is there evidence in this record of an actual discriminatory burden on foreign commerce, such as would exist in situations

If a domestic subsidiary earns income (whether from domestic or foreign activities), it is true that the dividends it pays to its parent are not taxed to the parent under the Iowa statute. But, under the Iowa scheme, the entire *earnings* of the subsidiary (whether from domestic or foreign activities) would be subject to state tax—by Iowa and other States—on an apportioned basis.[18] By contrast, only the portion of the foreign earnings distributed as dividends by the foreign subsidiary to the parent would be subject to state-level taxation, on an apportioned basis, under the Iowa scheme. By electing foreign incorporation of the subsidiary, the unitary business enterprise may thus achieve a benefit, rather than suffer a detriment, for the state-level tax then applies only to distributed dividends and not to all earnings derived by the foreign-incorporated subsidiary.[19]

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where foreign commerce is taxed more heavily than domestic commerce of the same type. See note 14, *supra*. Petitioner recites (Pet. Br. 9) that it received no domestic dividend income in 1981. It is not feasible on the record of this case to conduct a factual analysis of the relative burdens imposed by Iowa on foreign and domestic commerce even if one accepts the location of incorporation as a surrogate for the nature of the commerce involved.

[18] This discussion assumes that all States apply a tax scheme similar to that of Iowa. The States, in fact, differ widely in their tax treatment of income derived from the subsidiaries of a unitary business (see Pet. Br. 8-9 & nn.9-13). For example, California would tax an apportioned fraction of the entire earnings of a foreign subsidiary—even if it did no business in California—if the subsidiary were part of a unitary business enterprise that was subject to the California tax. See *Container Corp.* v. *Franchise Tax Board*, 463 U.S. 159 (1983). To determine whether Iowa's tax is *facially* discriminatory, however, it is relevant to observe how foreign and domestic commerce would fare if the Iowa scheme were applied by all States. See also note 29, *infra*.

[19] The brief of Amici Chevron, et al. (at 12-13) purports mathematically to illustrate the opposite conclusion. Amici candidly acknowledge, however, that their math "is somewhat simplified" (*id.* at 13 n.2). The most serious simplification in their analysis is that they neglect to account for the state-level tax that would be assessed on the entire *earnings* of the domestic subsidiary before it makes

3. Nor can it be said that the Iowa tax "facially discriminates" against corporations that elect to perform foreign commerce through use of foreign subsidiaries. Under the Iowa scheme, a domestic parent could establish a domestic subsidiary to act as the holding company for the stock of its foreign subsidiaries and to receive the earnings of those subsidiaries as dividends: if it did, the income received by the domestic holding company would be treated similarly by Iowa with income received by another domestic subsidiary that had conducted such commerce directly; moreover, any dividends paid by the holding company to the parent would be excluded from the parent's "taxable income" under federal law and the parent's "net income" under Iowa law.[20] Since the Iowa scheme allows the parent to elect a tax treatment for foreign subsidiary income that is identical to the tax treatment afforded to domestic subsidiary income, it cannot be said that Iowa "facially discriminates" against foreign subsidiaries, much less against foreign commerce.

This conclusion becomes even more apparent when one considers the three basic alternatives that a domestic parent corporation has for conducting the foreign commerce component of its unitary business: (i) the parent could conduct such foreign commerce directly, with the result that *all* of its earnings would be subject to appor-

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any distribution of dividends. Amici erroneously assume that it is appropriate to ignore the fact that the domestic subsidiary pays a state tax on its earnings in comparing the tax burden resulting from application of the Iowa scheme. In evaluating the alleged facial discrimination effected by the Iowa tax, it is not proper to ignore the operation of other provisions of the same statute. See *Halliburton Oil Well Cementing Co.* v. *Reilly*, 373 U.S. at 69.

[20] The earnings of the domestic holding corporation would be "subject to taxation" in the United States (26 U.S.C. 243(a)), even though the corporation would be entitled to seek a credit for the foreign taxes paid by its foreign subsidiaries. See 26 U.S.C. 11(a), 902. The dividends of the holding company to the parent would therefore be deductible in determining the taxable income of the parent corporation. See 26 U.S.C. 243(a).

tioned state taxation (see *Container Corp.* v. *Franchise Tax Board*, 463 U.S. at 166-169); (ii) the parent could form a domestic subsidiary to conduct such foreign commerce, with the result that *all* of the subsidiary's earnings (whether or not distributed as dividends to the parent) would be subject to apportioned state taxation (see *ibid.*); and (iii) the parent could form a foreign subsidiary to conduct such foreign commerce, with the result that *only those earnings distributed as dividends are subject to apportioned state taxation* under the Iowa scheme. It is not logical to view these options as describing a scheme that "facially discriminates" against foreign subsidiaries.[21]

In view of the virtually limitless variety of tax rates and practices applied in domestic and foreign jurisdictions, it would no doubt be possible to describe specific factual situations where the tax paid by the unitary business enterprise on the income of a domestic subsidiary would be less than the tax paid on the income of a foreign subsidiary under the Iowa scheme. The record of this case, however, provides no such examples. Moreover, such factual variations based upon the location of incorporation, rather than the location of the commerce involved, would not be constitutionally determinative. It is neither possible, nor constitutionally required, for a State to adopt a tax scheme that is perfectly neutral between foreign and domestic corporations in every conceivable factual application of its laws. It is sufficient that the state

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[21] Our discussion does not attempt to give account to local-level tax burdens that may be imposed in foreign nations. The record in this case fails to indicate even the existence, much less the nature, of such local-level foreign taxes (see Pet. Reply Br. In Support of Petition at 5-6). Nor is there any evidence to reflect the credits or reductions that foreign local governments would apply or allow. The record in this case is thus inadequate for examination of that topic, even if it were thought relevant. In evaluating the facial effect of the Iowa tax, however, it is evident that no discrimination against foreign-incorporated subsidiaries (much less foreign commerce) has been established.

scheme neither facially, nor actually, discriminates in a systematic fashion against foreign commerce.

4. While it is not critical to the constitutionality of the State's tax, we note that other provisions of the Iowa tax further mitigate the differential treatment that it affords to foreign and domestic subsidiary dividends. In particular, Iowa incorporates the federal practice of allowing a parent to deduct the foreign taxes it pays on dividends received from foreign subsidiaries. It is only, as in the present case, when the parent elects to take the federal tax credit for foreign taxes paid by itself or its subsidiary that it loses the federal deduction for taxes that it has paid on the foreign dividends. See 26 U.S.C. 275(a)(4); pages 3-4, *supra*. It is thus only when the parent elects the credit, instead of the deduction, that the result differs under the Iowa and federal schemes.[22]

B. The Iowa Tax Need Not Conform Precisely To The Federal Pattern

Although petitioner concedes at the outset (Pet. Br. 13) that Iowa is not constitutionally obligated to adhere to all of the specific features of the federal corporate tax scheme, the reasons why this is so are informative. It is, of course, the Internal Revenue Code, and not specific action of the Iowa legislature, that differentiates between dividends from domestic corporations and those from foreign corporations. In taxing an apportioned fraction of "net income," that it defines (with adjustments not at issue here) as federal "taxable income," Iowa accepts the results produced by the federal statute.

As this Court early pointed out, both Nation and State have power to tax. *Gibbons* v. *Ogden*, 22 U.S. (9 Wheat.) 1, 198-199 (1824). The "[c]oncurrent federal and state taxation of income" is thus "a well-established norm." *Mobil Oil Corp.* v. *Commissioner*, 445 U.S. 425, 448

[22] Petitioner's complaint against the Iowa tax thus reduces to the proposition that a credit, rather than a deduction, is required by the Constitution. There is no basis for such a contention. See *Container Corp.* v. *Franchise Tax Board*, 463 U.S. at 191-192 n.30.

(1980).[23] Under the Constitution, Congress has plenary power to tax and regulate, and even to discriminate against, "[c]ommerce with foreign Nations" (U.S. Const. Art. I, § 8, Cl. 3). But the action of Congress relevant to this case, and that of Iowa in following it in part, cannot properly be viewed as discrimination against foreign commerce.

Almost from the beginning of the federal income tax,[24] Congress has provided measures to prevent or minimize "the multiple taxation of corporate earnings as they passed from one corporation to another possibly within the same chain of beneficial ownership." 3 B. Bittker, *Federal Taxation of Income, Estates and Gifts* ¶ 90.2.3, at 90-16 (1981).[25] Section 243 is the current provision,

[23] Section 6103(d)(1) of the Internal Revenue Code contemplates that the Internal Revenue Service will assist and cooperate with state taxing authorities for it authorizes and requires that "return information," as defined in Section 6103(b)(2), be open to inspection by, or disclosed to, state agencies charged with the administration of state tax laws. Cf. *Parker* v. *Brown*, 317 U.S. 341, 368 (1943).

[24] See War Revenue Act of 1917, ch. 63, § 206, 40 Stat. 305.

[25] The exclusion for domestic inter-corporate dividends is related to the long-standing discussions concerning proposals to integrate the federal corporate and individual income tax. In response to congressional direction, a recently published *Report of the Department of the Treasury on Integration of the Individual and Corporate Tax Systems, Taxing Business Income Once* (GPO 1992) has analyzed the costs and distortions produced by the so-called classical system of taxation that treats corporations and their investors as separtate entities and levies tax at each level. As the Report points out, "Because the double tax on corporate earnings distributed to shareholders might become a triple or quadruple tax if corporations were taxed in full on dividends from other corporations, a corporate shareholder is entitled to a full or partial dividends received deduction (DRD), depending on its percentage ownership of the distributing corporation." *Id.* at 153. The Report notes that most of our major trading partners have achieved some degree of integration. *Id.* at 159-184. The problems of integration, and the costs of non-integration, have long been the subject of tax reform discussions. See, *e.g.*, McClure, *Integration of the Personal and Corporate Income*

allowing a deduction for dividends received by a corporation from corporations subject to the federal income tax in the amount of 100% in the case of affiliated corporations, and (in 1981) 85% otherwise. See note 5, *supra*. The earnings at the domestic corporate level that produced the initial dividend are, of course, subject to the federal income tax, and it is on that basis that the deduction with respect to domestic inter-corporate dividend payments is allowed. See also note 8, *supra*. The deduction, therefore, reflects not exemption of domestic corporate earnings from the federal income tax on corporations, but rather the removal or reduction, as the case may be, of a substantial tax barrier to the existence of subsidiary corporations, or to the use of the corporate form for doing business generally.

In the case of dividends received from foreign corporations, however, the situation is different. Their earnings from foreign activities have not been currently subjected to taxation by the United States, and become

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Taxes: The Missing Element in Recent Tax Reform Proposals, 88 Harv. L. Rev. 532 (1975).

Both Nation *and* States have flexibility in determining how corporate income should be treated for purposes of income taxation. Under the first federal income tax provisions, the income of some corporations was taxed directly to shareholders, not to the corporations. See *Collector* v. *Hubbard*, 79 U.S. (12 Wall.) 1 (1870). Compare the current treatment of the so-called "S" corporations (26 U.S.C. 1361-1379), most of the income of which is taxed to shareholders, whether distributed or not. Under the modern income tax, this Court at one point appeared to believe that even without benefit of statute, a distribution of earnings by a subsidiary corporation to its parent did not constitute income taxable to the parent corporation. *Gulf Oil Corp.* v. *Lewellyn*, 248 U.S. 71 (1918). Until the Internal Revenue Code of 1954, the federal income tax consisted of a "normal" tax, usually at fixed relatively low rates, and a graduated surtax. Until the Revenue Act of 1936, ch. 690, 49 Stat. 1648, corporate dividends were not included in the normal tax income of individuals but only in income subject to the graduated surtax. See, *e.g.*, Sections 11, 12, and 25(a)(1) of the Revenue Act of 1934, ch. 277, 48 Stat. 684, 692. For current variety in state patterns, see Pet. App. 73a-75a.

subject to such taxation only if, when, and to the extent that they are paid out as dividends to United States taxpayers.[26] This differentiation is not discrimination against the dividends from foreign subsidiaries. If anything, it favors the foreign subsidiary, since all of the income of domestic subsidiaries (whether from domestic or foreign commerce) is taxed as earned, while the foreign earnings of foreign subsidiaries are ordinarily taxed by the United States only if, when, and to the extent that they are distributed as dividends to United States taxpayers. Although Congress has constitutional power to discriminate against foreign commerce, it has not done so by virtue of the deductions allowed by Sections 243 and 245 and the concurrent taxation of the dividends paid by foreign corporations to domestic corporations.[27]

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[26] There are some special and limited exceptions, such as foreign personal holding companies (Sections 551-558) and so-called "Subpart F" income of controlled foreign corporations (Sections 952-964) that receive special treatment. They are not involved in this case. The portion of the dividends from a foreign subsidiary that is distributed from earnings that are derived from commerce within the United States, and that are subject to tax within the United States, may also be excluded from the gross income of a domestic parent corporation. 26 U.S.C. 245(a)(3); see note 8, *supra*.

[27] Not only is this non-discrimination evident on its face, it is further indicated by the fact that most of the income tax treaties with our trading partners contain provisions against discrimination, as does the Model Income Tax Treaty (Treas. Dep't), June 16, 1981, Treas. Dep't, art. 24, *reprinted in* 1 Tax Treaties (CCH) ¶ 211, at 10,582. See, *e.g.*, Income Tax Convention, Sept. 26, 1980, U.S.-Can., art. XXV, T.I.A.S. No. 11,987, *reprinted in* 1 Tax Treaties (CCH) ¶ 1903, at 21,022; Income Tax Convention, Aug. 29, 1989, U.S.-F.R.G., art. 24, Treaty Doc. No. 10, 101st Cong., 1st Sess., *reprinted in* 2 Tax Treaties (CCH) ¶ 3249, at 28,163; Income Tax Convention, Apr. 17, 1984, U.S.-Italy, art. 24, T.I.A.S. No. 11,064, *reprinted in* 2 Tax Treaties (CCH) ¶ 4803.49, at 33,016. We have been informed by the State Department, the Treasury Department, and the Internal Revenue Service that they have received no complaints or protests from other nations against the concurrent operation of Section 243 of the Internal Revenue Code and the taxation of dividends from corporations of the nations with which we have income tax conventions containing non-discrimination provisions.

This same conclusion applies to the tax provisions of States, such as Iowa, that tax all of the earnings of domestic subsidiaries but tax only the portion of the foreign earnings of foreign subsidiaries that is distributed as dividends to the unitary business enterprise conducting operations in their States.[28] Since, under the Iowa scheme, the dometic subsidiary income is fully taxed domestically when earned, an exclusion for dividends upon distribution by domestic corporations avoids a double tax at the state level; since the foreign subsidiary income is not fully taxed domestically when earned, an exclusion is not necessary to avoid a double tax at the state level.[29] There is thus no discrimination against foreign-source income either by the federal government or by the States (including Iowa) that base their corporate income tax upon federal "taxable income."

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[28] Since petitioner's foreign subsidiaries paid aggregate dividends of $10,181,815 to petitioner in 1981, while petitioner received no dividends from domestic subsidiaries (or, as far as the record shows, from any domestic corporations), it seems obvious that Iowa's corporate income tax did not deter petitioner from investing in and carrying on commercial activity abroad. Nor did it discriminate against non-existent domestic dividend income.

[29] See also note 8, *supra*. Nor does a double tax result at the state level because, for example, California applies an apportioned tax to the *earnings* of the foreign subsidiary that is part of the unitary business (see note 8, *supra*), while Iowa applies an apportioned tax only to the distributed portion of those earnings. The result, instead, favors the foreign subsidiary because less than its entire income may be taxed under the Iowa scheme.

The fact that five States have no corporate income tax on either domestic or foreign corporations (see [1 All States] State Tax Guide (CCH) ¶ 10-060, at 1026 (Dec. 31, 1990)) does not alter this conclusion. It only reduces further the tax burdens on all corporations.

C. *Japan Line, Ltd.* v. *County of Los Angeles* Does Not Prohibit State Taxation of Dividends That A Domestic Corporation Receives From A Foreign-Incorporated Subsidiary

By referring to this Court's decision in *Japan Line, Ltd.* v. *County of Los Angeles*, 441 U.S. 434 (1979), petitioner appears to suggest (Pet. Br. 13-14, 15 n.17, 21-22) that, in view of the possibility of multiple taxation of the earnings of foreign-incorporated subsidiaries, Iowa should be required to abstain from taxing its apportioned share of foreign-source dividends. An argument to that effect was advanced somewhat more explicitly in *Mobil Oil Corp.* v. *Commissioner*, 445 U.S. 425 (1980), on facts precisely paralleling the facts of this case, and was explicitly rejected (*id.* at 446-449), along with other arguments challenging the power of a State to impose a corporate income tax upon the fraction of foreign-source dividends apportioned to it.

Generally, as a commercial enterprise expands internationally, it runs some risk of multiple claims of power to tax. Separate incorporation may reduce, but is unlikely to eliminate, the possibility of multiple taxation. Internally, within the United States, the requirements for apportionment imposed by decisions of this Court resolve the most troublesome of multiple claims to tax. The United States has also sought to reduce the burdens of multiple taxation upon its citizens and domestic corporations by means of the deduction for foreign income taxes allowed by Section 164(a)(3), or, at the election of the taxpayer, the credits for foreign income taxes allowed by Sections 901 and 902.

As we have noted, "[c]oncurrent federal and state taxation of income" is the "well-established norm." *Mobil Oil Corp.* v. *Commissioner*, 445 U.S. at 448. Petitioner accordingly raises no question concerning the fact that it normally pays annual income taxes to the federal government and, concurrently, to the States in which it does business (including Iowa) on income apportioned to the several States. When we look to petitioner's foreign

subsidiaries, the foreign nation in which the subsidiary is organized and does business is the sovereign and, as such, stands in the place of the United States and can be expected to tax income earned within its borders. The burdensomeness of its taxation is, of course, a factor that petitioner took into account in deciding to expand its operations into that nation. As income is earned in the foreign nation, neither the United States nor Iowa seeks to tax it.

When, however, the foreign subsidiary declares a dividend from its foreign earnings (see note 8, *supra*), the possibility of multiple taxation beyond the usual norm arises. Petitioner, a United States taxpayer, will have received a dividend includible in its gross income pursuant to Section 61(a)(7), *not* giving rise to a deduction under Section 243, and therefore included in its taxable income as defined in Section 63(a), subject to federal income tax, and, as "net income" for Iowa purposes, to Iowa's corporate income tax upon a properly apportioned fraction. That, of course, is not the end. The foreign nation is likely (as we do in Sections 1441 and 1442 of the Internal Revenue Code) to regard a dividend declared by one of its corporations as income to the recipient having a source within its borders and, if the recipient is not one of its nationals, subject to withholding.

It is in precisely that situation that it is the legislated policy of the United States, in the interest of its citizens and enterprises, to yield to some extent its power to tax and to allow its recipient taxpayer to take a deduction from gross income in the amount of the foreign income taxes paid, pursuant to Section 164(a)(3) or, at its election, to take a credit, pursuant to Sections 901 and 902, against its federal income tax for the foreign income taxes paid. That leaves, in this case, Iowa and the foreign nation as concurrent taxing powers, just as Iowa and the United States would be in the case of domestic income. There is no basis for the somewhat oblique sug-

gestions of petitioner and its amici[30] that Iowa should be required to grant a credit for foreign taxes paid simply because, to mitigate double taxation at the national level, the United States has chosen to do so. See *Container Corp.* v. *Franchise Tax Board*, 463 U.S. at 191-192 n.30.

If petitioner had chosen to take the deduction allowed by Section 164(a)(3), that would have reduced its federal "taxable income" and its Iowa "net income" by the amount of the foreign income taxes paid. Presumably in its own self-interest, it chose to take the credit rather than the deduction (Pet. App. 32a), leaving its federal "taxable income" and its Iowa "net income" unreduced. Since the record does not show the fraction of petitioner's "net income" that was apportioned to Iowa, we do not know the amount by which its Iowa taxes would have been reduced had it chosen the deduction. In any event, it was petitioner's choice, not Iowa's, that its Iowa "net income" remained unreduced by the amount of foreign taxes paid with respect to the dividends it received from foreign subsidiaries.

II. THE IOWA TAX DOES NOT VIOLATE THE EQUAL PROTECTION CLAUSE

Petitioner argues (Br. 24-30) that the Iowa tax discriminates against foreign commerce in a manner that violates the Equal Protection Clause. Since, as we have discussed, the Iowa tax does not discriminate against foreign-incorporated subsidiaries (much less against foreign commerce), there is no violation either of the Commerce Clause or of the Equal Protection Clause. The different treatment of dividends received from foreign-incorporated subsidiaries, as compared to those from domestic-incorporated subsidiaries, serves legitimate, rational state purposes. See Pet. App. 9a-10a; pages 9-23, supra. It therefore does not deny petitioner the equal

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[30] See Pet. Br. 6-7 & nn.7, 8; Amici Avon Products, et al., Br. 3 n.2; Amici Chevron, et al., Br. 13 & n.2.

protection of the laws. See *Amerada Hess Corp.* v. *Director*, 490 U.S. at 80; *Metropolitan Life Ins. Co.* v. *Ward*, 470 U.S. 869, 881 (1985).

CONCLUSION

The judgment of the Supreme Court of Iowa should be affirmed.

Respectfully submitted.

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